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End of Year Planning: Getting Comfortable with Making Large Gifts

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With 2011 coming to a close, we would like to take the opportunity to remind you of the unique tax environment which we are in, allowing for $5 million of lifetime gifts (per individual, $10 million per married couple) to be made tax-free. If no action is taken by the government, the gift tax exemption will return to $1 million beginning January 1, 2013. It is rumored, however, that the "Super Committee" will reduce the gift tax exemption before then to either $3.5 million or $1 million.

As people are being encouraged to make gifts to take advantage of the significant exemption available, many are not comfortable for one reason or another with an immediate transfer of significant sums of money to children or grandchildren. While it is important not to let tax motivations control planning and gifting decisions, we provide below some recommendations that we hope will assist in making gifting decisions appropriate for you and your family.

Discuss with your Children

A crucial step in this process is talking to your children where possible, explaining why you are making the gift and what your expectations are. Equally important is to ask your children what they think about the gift, how it may or may not change things for them. If you are still unsure as to whether you want to make a gift, it might be worthwhile to ask for input from any adult children whose judgment you trust as to the best way to take advantage of the current gift tax exemption, if at all. We also understand that it is often the case that parents would like to treat their kids equally but need to treat them differently. This might therefore require taking a different approach with each child.

The nature of the conversation will be dependent on the age of your children. A conversation with adult children may focus more on whether they want the money and, if so, how they would like to receive it. For instance, would they prefer to receive it outright or in trust (to protect against creditors or divroce)? Or have it given to them to assist with a particular purchase or endeavor? Or would they prefer it be put in trust for their children? For young adults, the conversation may be more geared to why you are making the gift to allay any fears that you might have of inhibiting any ambition or undermining their independence; to avoid resulting expectations that similar gifts will be made in the future. For young children, the appropriate time to have the conversation is likely closer to when they would start having access to the money.

Make Gifts in Trusts

Many people are concerned with the effect that the receipt of a large amount of money would have on a child, whether a child is ready for the responsibility of receiving a large amount of money or whether the child is financially savvy enough.

Making a gift in trust is an effective way to control the child's access to the money. In creating the trust, you can choose at which ages or upon which events distributions of principal (if any) should be made to the beneficiary. The trust could be written to allow the trustee maximum flexibility for making distributions, to allow the trustee to withhold distributions for purposes of abusive behavior, for instance, and to make more liberal distributions for purposes of buying a home, as an example. By giving the trustee these flexible powers, the maturity and development of a child which are not known at the time the trust is created can be taken into account at a later date. Given the critical role of the trustee, it is important to give special consideration to who you name as trustee of any such trust.

Make Gifts for a Specific Purpose

Making a gift for a specific purpose, such as to assist in starting a company or purchasing a home, is one way to avoid any fears that a child will squander the money, or that a spouse will have unwanted access to the money. More importantly though, many people find making a gift for a specific reason more satisfying than transferring money sooner than one otherwise would solely for tax purposes.

If none of your children are currently in need of significant assistance, it is possible to make a gift in trust for the specific purpose of being held until such time a child wants to purchase a home or make a similarly expensive purchase or investment. The hope is that the trust fund will grow in value until the need arises.

Use Gifts as an Educational Tool

Another way to productively use the gift tax exemption is to make a gift for the purpose of teaching your children how to manage money, to get them used to the idea that they may be inheriting significant amounts of wealth at some point in the future. This can be done by creating a trust and giving the beneficiary powers to manage the trust assets but no power to make distributions. In explaining this gift to the child or children, you might emphasize that you are making this gift to teach them to manage money, and incentivize them to responsibly manage it rather than spend it all. You might also encourage the recipients to take a financial planning course or to hire a financial advisor to assist them.

Another option is to form a family investment limited liability company or limited partnership. The entity could be structured in such a way to require your children and/or grandchildren, as the case may be, to learn to work together in making investment decisions. If there is a family business that you are hopeful to some day pass on to your children, this might be a helpful step in determining whether they work well together in the business context.

In summary, while there is an unusually large gift tax exemption available at this time, it is important to utilize it only to the extent with which you are comfortable. We hope the above recommendations will encourage you to think more about the possibility and, should you be so inclined, to assist you in deciding how best to make the gifts.

Please consult with your advisor should you have any questions.
